FORAGER

31 March 2017

VALUE REALISATION PROJECT
Why 2017 is likely to see us wield our influence more aggressively.

A JUMBO PILE OF CASH
Despite the recent share price appreciation, the stock remains materially undervalued.

DOUBLING DOWN ON MATRIX
The Fund added to its investment in this unloved oil services company.

WHOLESALE VALUE FUND MARCH 2017 QUARTERLY REPORT

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WHOLESALE VALUE FUND

FACTS

Fund commenced	2 September 2004
Minimum investment	$10,000
Income distribution	Quarterly
Applications/Redemption	Weekly

UNIT PRICE SUMMARY

Date	31 March 2017
Buy Price	$1.5435
Redemption Price	$1.5359
Mid Price	$1.5397
Portfolio Value	$28.4m
Distribution	2.5c

THE YEAR OF RELEASING SHAREHOLDER VALUE

While it can be easy to identify the value locked inside a business, the ultimate success of an investment depends on whether value can be extracted for the benefit of shareholders.

Table 1: Summary of Returns as at 31 March 2017

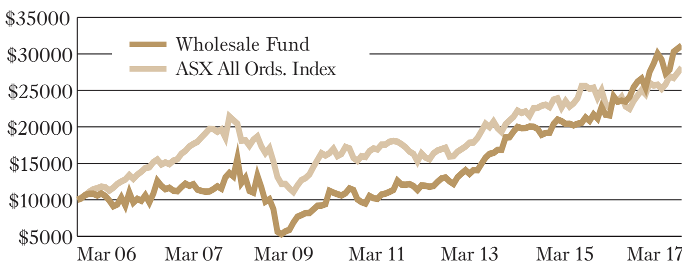
	Australian Fund	S&P All Ords. Accum. Index
1 month return	1.38%	3.16%
3 month return	11.80%	4.50%
6 month return	3.66%	9.11%
1 year return	22.48%	19.49%
3 year return (p.a.)	16.46%	7.56%
5 year return (p.a.)	19.24%	10.66%
Since inception* (p.a.)	9.65%	8.63%

*Inception 2 September 2004
Investments can go up and down. Past performance is not necessarily indicative of future performance.

Value investing is all about identifying a company whose shares are trading on the stockmarket at a significant discount to their intrinsic value. Calculate the value of the underlying business, subtract any debt and divide the result by the number of shares on issue. Compare this value per share to the share price and buy when the gap between the two is significant. Or so the theory goes.

In practice, value investors (including ourselves) often get trapped in companies with significant underlying value that perennially trade at a discount to that value. That happens because the assets are not really worth what we think they are worth, or because the value doesn't get returned to shareholders and management misallocates resources at low or negative rates of return.

Chart 1: Comparison of $10,000 invested in the Australian Shares Fund and ASX All Ords. Index



Source: S&P Capital IQ
Investments can go up and down. Past performance is not necessarily indicative of future performance.

In the Forager Wholesale Value Fund, not getting trapped is going to be particularly important over the coming year or so. In a buoyant market where attractive opportunities are becoming less prevalent, realising the value underlying some of the key holdings is going to be fundamental to overall returns.

Already this year the Fund has rejected a bid from **CIMIC Group** (CIM) for its **Macmahon** (MAH) shares. Macmahon is the perfect example of a company sitting on a lot of assets that hasn't been able to convert their value into returns for shareholders. That would usually make a takeover bid a welcome relief.

CIMIC's bid was very opportunistically timed, however, and we didn't think it attributed an appropriate amount of value to the business. The bid has applied a blow torch to management and they probably have six months to prove they can generate value for shareholders before CIMIC makes another attempt.

There are a few other examples where a blow torch might be necessary. Two standouts are **Jumbo Interactive** (JIN) and **Enero** (EGG). Both companies have underappreciated assets that could make them worth a lot more than their current market capitalisations.

Table 2: Top 5 Investments

Macmahon Holdings	9.7%
Reckon	8.4%
NZME	8.1%
Cardno	6.4%
Jumbo Interactive	6.4%

Investments can go up and down. Past performance is not necessarily indicative of future performance.

A JUMBO PILE OF CASH AND FRANKING CREDITS

Jumbo Interactive is certainly not a holding that has hindered recent returns. The share price of the online-seller of lottery tickets is up about 40% over the last year and 70% over the last two years.

It is a good business. Costs are relatively fixed and lottery players are flocking online in big numbers. With a database of more than two million customers, Jumbo's profitable Australian business is the largest independent seller of lottery tickets in the country. And the company has just closed its business in Germany, which made a loss of $2.6m last financial year.

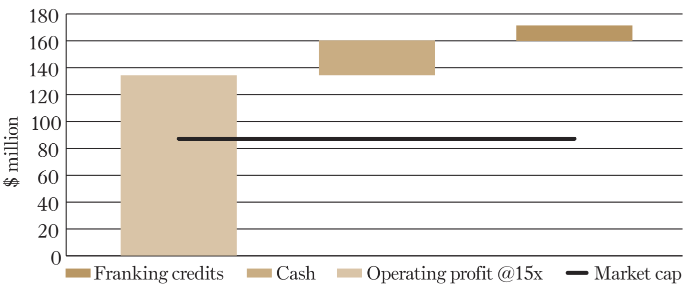
"VALUE INVESTING IS ALL ABOUT IDENTIFYING A COMPANY WHOSE SHARES ARE TRADING ON THE STOCKMARKET AT A SIGNIFICANT DISCOUNT TO THEIR INTRINSIC VALUE."

The perennial risk is that Jumbo doesn't run its own lotteries. It is merely an authorised retailer for **Tatts Group** (TTS), which has managed to buy itself a monopoly on lotteries in most states in Australia. Jumbo is an ongoing reseller of Tatts' lotteries with no long term agreement. This means that at any time it wishes, Tatts can terminate Jumbo's right to sell tickets.

But we believe recent developments have reduced this risk. We have written about them in the October monthly report and won't go into too much detail. But we maintain the view that the emergence of Lottoland in Australia will strengthen Jumbo's competitive position. It improves the likelihood that a merged Tatts/Tabcorp entity will recognise the strategic value in Jumbo's customer database and sign a long-term deal. It also sets a precedent for Jumbo to obtain its own licence and modify its business model to selling bets on domestic and overseas lotteries, should its relationship with the merged entity turn sour.

Despite all the recent positives and share price appreciation, the stock remains materially undervalued. But how undervalued?

Chart 2: Jumbo Valuation



And how to extract that value?

Jumbo's database of two million customers is a valuable asset. To put it in perspective, German peer Lotto24 has 1.2m customers and a market capitalisation of $302m. Granted, Jumbo's database is much older (the two companies have roughly the same number of active players) and Lotto24 is growing much faster, but Jumbo's market capitalisation is just $86m.

Jumbo is in a strong financial position with cash of $26m and franking credits of $10m. Yet the board has been painfully conservative when it has come to capital management. Jumbo has paid out just 34% of its earnings in dividends over the last 5 years.

With the geographic expansion strategy abandoned, Jumbo is now a business with minimal capital requirements. Yet at its recent half year result, it declared a 3.5 cents per share dividend, despite earnings per share of 5.9 cents. And excluding the discontinued German business, earnings per share would have been 7.9 cents.

The 2017 financial year is shaping up as a poor one for jackpots, a key driver of Jumbo's revenue. But in a normal year for jackpots, Jumbo should be able to make $9m of profit equating to $0.20 per share. Paying this to shareholders as a fully franked dividend would see the share price trade materially higher. A $0.20 per share dividend trading on a 7% yield equates to $2.86, well above the current share price of $1.90.

And it has enough franking credits to return at least $0.30 per share of excess cash in the form of a special fully franked dividend, which we don't believe would detract from the values estimated above.

We have made our thoughts clear to the board and will be taking more forceful action at the AGM if we haven't seen progress by then.

ENERO CAN'T PROSPER ON ASX

Marketing conglomerate Enero Group has been a volatile and frustrating investment in recent years. Following a near death experience under previous management, the current management team have worked tirelessly to right the ship. Progress was looking promising, with margins at the earnings before interest, tax, depreciation and amortisation level increasing from 1.4% in 2012 to 7.1% in 2016. But in the last 10 months things started to go wrong. The Brexit vote led to the depreciation of the pound, where Enero derives almost half of its revenue. This was followed by UK client timidity with the final kick in the guts being the loss of its largest client, Virgin Atlantic, which was 7% of revenue.

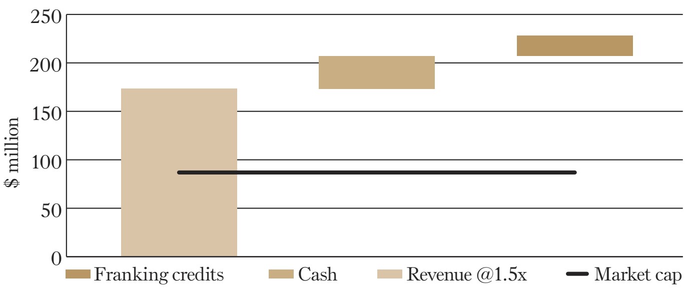
Where does that leave things now? Trading at more than 20 times 2017's anticipated profit, the stock looks expensive on an earnings multiple basis. But adding up the individual components of value in this business, it looks absurdly cheap.

The current $1.00 share price equates to a market capitalisation of $86m. For this shareholders get $34m of cash, $22m of franking credits and a motley collection of marketing businesses that generate $110m-120m of revenue. One of them, leading global PR firm Hotwire, could be worth $40m-$50m itself.

Compared to global peers, $1 per share is an absurdly low price. Enero's peers trade on an enterprise value to revenue multiple of 1.5 to 2 times. Enterprise value refers to the total of a company's market capitalisation and its net debt. Since Enero has a net cash position, its enterprise value is just $52m. If it traded on the same multiples as its peers, its enterprise value would be up to four times larger than today. This equates to a share price north of $2.00.

"IN A NORMAL YEAR FOR JACKPOTS, JUMBO SHOULD BE ABLE TO MAKE $9M OF PROFIT EQUATING TO 20 CENTS PER SHARE. PAYING THIS TO SHAREHOLDERS AS A FULLY FRANKED DIVIDEND WOULD SEE THE SHARE PRICE TRADE MATERIALLY HIGHER."

Chart 3: Enero Valuation



Enero's depressed share price is mostly a function of being sub-scale. Its operating margins before corporate costs are comparable to global peers (17% vs 20% global average). But a relatively low revenue base results in high corporate overheads as a percentage of revenue (6% vs 2% global average), which chews up a third of that operating profit. With a focus on reducing overheads in recent years, we believe there is little more that can be done to reduce corporate costs.

The only way to improve margins is to increase scale. But this could take years and involve risky acquisitions. A quicker and less risky solution would be for a global peer or private equity company to acquire Enero. It no longer makes sense for this business to be a listed company.

The other main reason for Enero's low share price is its inability to pay dividends. This relates to a historical agreement with the vendors of its acquisitions. A key contributor to Enero's near death experience in 2010 was its large deferred consideration liability for acquisitions made. Enero underwent a restructure and capital raising with modified earnout agreements. This restricted Enero from paying dividends or buying back shares until September 2018 unless the liability had been paid back earlier. This restriction has meant Enero's cash and unused franking credits are not being valued by shareholders.

Fortunately, the deferred consideration liability is down to $5m. We believe management may be able to renegotiate the vendor agreement to bring forward the payment of dividends (presumably at a small cost).

Once the restrictions are behind the company, management need to be aggressive. We estimate that the company has about $20m of excess cash (cash not required for the day to day running of the business). A special fully franked dividend of $0.23 per share plus a commitment to a high future payout ratio would keep shareholders happy while management work out how to best deal with the scale issue. Having held the stock for almost seven years, it is time to roll the sleeves up.

INVESTING IN AN OIL PRICE RECOVERY

The oil price's stunning decline of the past four years from above US$100 per barrel to below US$50 has wreaked havoc across the oil industry globally, providing investors with a prospective place to look for cheap stocks. While internationally there were, and still are, plenty of them, we are not so lucky in Australia. The fortune of our local energy companies relies more on the price of gas than that of oil.

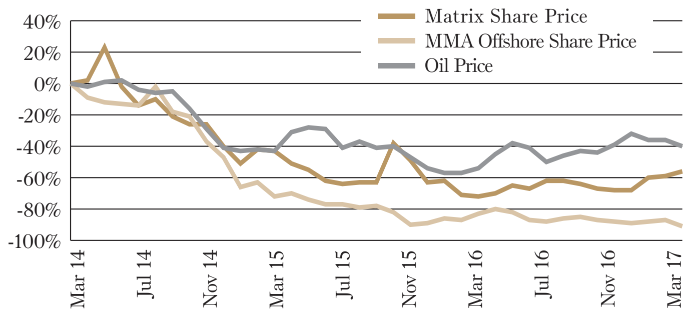
In the Australian stockmarket, exposure to a recovery in the oil price is better attained indirectly through investing in the oil services space. As pointed out in the **January monthly report**, the Fund holds four stocks that should benefit indirectly from a higher oil price. These are **Cardno** (CDD), **GR Engineering** (GNG), **LogiCamms** (LCM) and **Matrix Composites & Engineering** (MCE).

The Fund also owned shares in **MMA Offshore** (MRM). We sold them last year, adding to the existing investment in Matrix.

MMA owns a fleet of vessels that it charters to the offshore oil industry mainly in Western Australia. These vessels are used to tow and handle anchors for drill rigs, construction vessels and barges. They are also used to transport personnel and supplies to and from offshore oil platforms.

At the time of the Fund's investment in early 2015, MMA had an enterprise value of $700m and $1.3bn of tangible assets mostly in the form of relatively new vessels with an expected life of at least 20 years. While a discount to these assets was warranted due to a chronic oversupply of such type of vessels, we thought that a nearly 50% discount was too big.

Chart 4: Oil Price Change and Performance of Matrix and MMA Shares



Source: S&P Capital IQ

On the other hand, Matrix manufactures riser buoyancy systems – cylinders of plastic foam that help to keep the pipes connecting drilling vessels in position on the bottom of the sea. After the oil price collapsed, demand for new drilling ships, and consequently Matrix's products, evaporated. The company's order book shrunk from US$110m in December 2012 to US$22m in December 2016.

"WHILE BOTH MATRIX AND MMA STAND TO BENEFIT SIGNIFICANTLY FROM A RECOVERY IN THE OIL PRICE, THE RISK-RETURN PROFILE OF THE TWO INVESTMENTS HAS DIVERGED MEANINGFULLY."

The Fund started buying Matrix shares in late 2015. The company then had an enterprise value of only $45m but tangible assets of more than $150m. The bulk of these were the result of years of investment, building the world's largest and most efficient manufacturing facility of its kind. While the dollar value of this facility was, and still remains, tightly linked to the state of the oil market, we thought it represented a strategic asset that no competitor could justify nor afford to replicate.

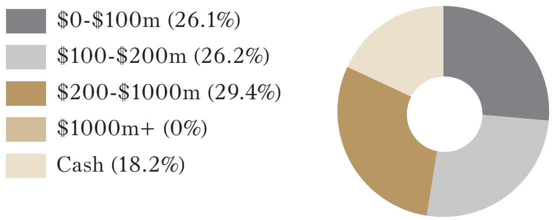
DOUBLING DOWN ON MATRIX

While both Matrix and MMA stand to benefit significantly from a recovery in the oil price, the risk-return profile of the two investments has diverged meaningfully.

While Matrix repaid all of its debt, MMA's financial position deteriorated. The latter failed to sell enough vessels to reduce its debt burden, which at the end of 2016 stood at $400m, four times higher than its market capitalisation. So, Matrix's ability to wait for an oil price recovery was enhanced, while MMA's decreased notably. Importantly too, Matrix's management can now focus on operating its business as efficiently as possible. MMA's management doesn't have this luxury, faced with ongoing negotiations with bankers while trying to run a business.

While we sold the shares at a significant loss, this could prove to be a good decision given its financial predicament.

Chart 5: Portfolio Distribution According to Market Cap



MMA's failure to sell its boats at a small fraction of the price it paid only a few years ago highlighted how greatly we underestimated the level of oversupply in that market. It might be hard for MMA to earn a decent return on its discounted assets even if the industry improves meaningfully. On the other hand, Matrix's industry has become more attractive with one of its main competitors going broke and another one losing credibility with shipyards due to quality control issues. As the last player standing, Matrix should be able to earn good returns once the industry turns.

Despite these contrasting developments, the share price of both companies kept falling throughout 2016. So much so that we purchased additional shares in Matrix at a discount to even its *current* tangible asset backing of $0.44 per share. This price implied no value for its leading manufacturing facility. It could be a five year wait for a meaningful turnaround in Matrix's business, but we expect it to be a worthwhile wait.

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